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SSM and ECB: Supra-Nationalization of Banking Politics

1 Background

In November 2014, Europe's Single Supervisory Mechanism (SSM) will be launched. In fact, for Europe's banking industry – that is, supervisees but also supervisors – the SSM has been in place ever since the comprehensive balance sheet review was contemplated and then implemented since the end of 2013. The SSM is part of an indeed ambitious project: the three-pillared banking union, whose second part is a set of tools to handle banks in trouble, be it by restructuring, downsizing or unwinding them (i.e. market exit) and whose third part is a harmonized deposit guarantee scheme.

The two-and-a-half legged stool which emerged after barely two years of construction is not exactly according to the blueprint as it might have been conceived by a benevolent (platonic) stool-maker's king. That is, there is substantially less commonality – common backstops – than federalists might want to see. But the new setup, still very much a construction site, is a far cry from what was deemed achievable – or, better, appropriate – in the euro area before the crisis broke in the summer of 2007. In fact, it needed two additional ground-shaking developments (the near implosion of financial markets in the fall of 2008 as well as the Greek sovereign debt crisis plus its fallout, beginning in the fall of 2009) before Europe – the Commission, the Parliament and the Council – could convince itself to move. This reluctance to adapt becomes evident when interpreting the de Larosière Report from today's angle. This very influential work, which was implemented in a surprisingly faithful way, led to the European System of Financial Supervision, encompassing a network of three micro-prudential European supervisory authorities, complemented with the macro-prudential European Systemic Risk Board (Grande, 2011). At the time, de Larosière was seen as pushing the (federalist) envelope, going to the limits of what many European nation states were prepared to accept. This is palpable, for example, in the setup of the European Systemic Risk Board (ESRB), which attempted to delicately accommodate national prerogatives and preferences. It became even more evident after the Deauville signal on private sector involvement (October 2010) ultimately forced Europe's hand in changing the temporary European Financial Stability

Facility (EFSF) into a permanent European Stability Mechanism (ESM). Some – maybe even many – see this as being incompatible with a proper reading of the European Treaties, more specifically with the no bail-out clause (Art. 125 TFEU). From this angle, requesting (national) sovereignty in decision-making simultaneously implies bearing the consequences, i.e. taking responsibility for your acts. Otherwise, with

perimeters between competence and responsibilities diverging, incentives will be distorted.[1]

There are basically two ways of harmonizing radiuses: devolving (nationalizing and coordinating) or centralizing (supra-nationalizing). The SSM (as well as the banking union more generally) opts for the latter: centralizing. This represents a distinct rupture with initial ideas

about monetary union, a change of paradigm in a literal sense: A defining part of the national policy (and political) domain is now supra-nationalized, namely the politics of banking. These brief remarks focus on how the re-orientation came about – very protractedly at first, but then abruptly. This has been less a cognitive issue – how to appropriately face externalities in structurally integrated financial markets. Institutional change always betrays the tensions of the situation. Nothing really new here: Therefore, most such innovations are children of crises. Paradigms are changed when they become untenable. This requires as a rule: crises.

In the following, we will – summarily – touch on two topics: the denationalization of banking policy, meanwhile seen (after the supra-nationalization/Europeanization of monetary policy) as a logical corollary of the common currency, i.e. "one market, one money – one supervisor", its inexorable complement. Inextricably linked to this issue is the question of how to institutionalize the interaction between monetary and banking policy. But first, we will start with a conceptual point.

2 Monetary and Banking Politics in a Monetary Union

Courses on money in German-speaking (and other) universities used to be offered under the title: *Geld und Kredit*, at least until the mid-1990s. This also highlighted the unavoidable link between outside (high powered, central bank) money and inside bank money, as created by lending (and deposit-taking) institutions. Those courses also had strong relationships with principles of banking classes. Nowadays, with the slicing-up of banks' value chains, in heeding this tradition, more of an emphasis is put on financial markets, which increasingly serve as functional substitutes (consider asset-backed securities, etc.). One could read this as reflecting the strong link between monetary policy and banking politics.

Adding to this perspective is an important argument of Charles Goodhart, impeccably developed in his "two concepts of money". One view, which he calls the "Mengerian" view, stresses money's intrinsic value in use. Having

[1] *The German Constitutional Court has twice deliberated on this. Here is not the place to contemplate this debate, which is very controversial amongst euro area members. However, both cases were concerned with institutional innovations which were deemed crucial to prevent the euro area from falling apart. In both cases, the ECB was forced to take unconventional measures, as its confreres had done earlier (and still do). The opportunity costs of not acting had been judged as prohibitive (my view also). But this setup of the game clearly makes the ECB, given that it is the strongest player at the European level, highly vulnerable to both financial as well as fiscal dominance. There is a continuous incentive to re-optimize.*

the lowest information costs, it is the most effective device to economize on search and transaction costs. The competing understanding insists that fiat money's value largely emanates from the power of the backing institution, i.e. the state. For Goodhart, these are the Cartalists, which one could rightfully also call the "Knapperians".[2]

While analytically neater (since arithmetically tractable), Mengerians have politically less pertinence than Knapperians, the latter insisting on the determining influence of institutions. From this perspective, one could have wondered ever since the launch of EMU whether there were too many national concepts of banking as well as too much diversity in supervisory philosophies before the crisis. However, these thoughts showed mainly implicitly. Reference was made to the heterogeneous structure of financial intermediation and its consequences for the (uneven) transmission of monetary policy measures. But debates remained largely muted, the more so since the great convergence of interest rates (over the whole spectrum) could reasonably be interpreted as an ever deeper integration of markets (see the ECB's various integration reports). Also, major attempts at creating a common, integrated financial market environment were made, most importantly all the efforts around the *Financial Services Action Plan*, implemented since the early 2000s with its more than 40 directives and regulations (including directives on capital requirements or investment/markets in financial instruments, etc.).

Nonetheless, as an immediate upshot of the financial crisis, the euro area saw its markets disintegrate. This held particularly true for interbank (wholesale) money markets, those markets which had been most swiftly as well as deeply integrated. The ECB was forced to become an intermediary, standing in for banks not prepared to go cross border. Nationality of financial instruments became pertinent again. Spreads widened. With ever more reluctant international investors, in the so-called periphery, a detrimental loop between fragile banks loading up on domestic public debt and endangered sovereigns arose.

The ECB's coinage of an "impaired monetary transmission mechanism" – highlighting the asymmetric impact of monetary instruments – correctly captures this inevitable link between banking politics and monetary policy.

3 EMU: Monetary Policy Without Banks

The canonical reference for Europe's common currency was, of course, the optimal currency area (OCA) literature (de Grauwe, 1994). Here, the core question was about functional substitutes to the nominal exchange rate. However, in practically determining the geography of Europe's money, OCA was barely acknowledged (Gretschmann and Kotz, 1998). Moreover, it was also seen from the very beginning that monetary integration would have a strong impact on financial market integration, and vice versa. Just think of the very influential EU Commission report on *One market, one money* alluded to before. Therefore, a harmonization of regulation and its implementation was seen as a logical corollary (Kotz, 2001). But the more encompassing idea of a banking union was seen as quite unrealistic, almost impossible to accomplish for political reasons. In fact, what was

[2] *After Georg Friedrich Knapp's Staatliche Theorie des Geldes (1905), stressing that (fiat) money is first and foremost a legal construct or product.*

dubbed banking union by Nicolas Véron in 2009 had been discussed in the mid-1990s by Charles Goodhart or Gary Schinasi, the latter mainly referring to the U.S. financial setup, its historical evolution, more precisely: the crises which forced a union in banking (sort of) on the United States. (In the U.S., still today, even after passage of the Dodd-Frank Act, there is much of state involvement in banking and, especially, insurance regulation.)

The banking union idea was pondered again in the 2007 to 2009, against the background of emerging "financial market turbulences", as the contemporaneous lingo downplayed it, which then morphed into the Great Financial Crisis in the fall of 2008. But these were purely academic debates that met with insurmountable resistance in the real world of politics and the web of industry interests. Indeed, for some reason, the academic blueprints supposed a level of federalism (mutualization) which did not exist. More realistically, the reach of regional solidarity probably shrank. Only when facing the potential break-up of the euro, with its potentially gigantic opportunity costs, did more radical institutional innovations become fathomable. With two unconventional policy instruments – very long-term refinancing operations (with full allotment, given collateral availability) and the outright monetary transaction commitment – the ECB served as a trail-blazer and ultimate underwriter of this new approach.

As already mentioned, on the drawing board banking union was as a three-legged stool – including in addition to the supervisory function also recovery and unwinding tools as well as Europeanized deposit insurance. The two latter legs, however, would imply a mutual solidarity between euro area taxpayers which would have to come with a commensurate sharing in decision-making, currently beyond political feasibility.[3] Nonetheless, as concerns the common supervisory approach, here most of the way as outlined in academia has in fact been covered.

The SSM is the centerpiece: it is about reading from the same script book (Single Rule Book) and, at least as important, implementing principles in a consistent way across member states. Rather explicitly, this new approach also acknowledges that the previous, decentralized setup had been found wanting in rising to the challenges of the crisis. This was in particular the case in managing its cross-border externalities, inevitably involved with and amplified by deeper integration of financial markets. It needed in fact two crises to go substantially beyond de Larosière, who, to reiterate, was at his time seen as over-ambitious. Academics, most obviously, not being politically responsible, enjoy the luxury of always being more straightforward, more consistent and less messy. Alas, it is easy to be courageous when you are not in charge, which means not dealing with conflicting claims and trade-offs. Therefore, it is important to understand where impediments to implementation come from.

Since time immemorial, banking policy has been an important lever of national politics more generally. The highly instructive *Varieties of Capitalism*

[3] *Nonetheless, the recovery and resolution directive, as agreed upon by the EU Council in March and adopted by the EU Parliament in April 2014, takes significant steps in that direction. In principle, banks should be resolved without taxpayer support. In worst cases, however (and they do happen!), a Single Resolution Fund, starting with national compartments, to be mutualized after eight years, will be available as a backstop. Legally, this is based on intergovernmental agreements.*

approach (Hall and Soskice, 2001) prominently insists on banking (financial market) philosophies as defining, complementary elements of different models of capitalism. They refer, for example, to the Hausbank principle and the close, long-term horizon relationship which used to prevail in systems dominated by Universalbanks (Elsas and Krahnen, 1998) (Ewald Nowotny, in his introductory remarks to this Volkswirtschaftliche Tagung, stressed this point also.) Clearly, those institutions are part and parcel of a distinct institutional setup with a substantial degree of complementarity (between the spheres) and consistency. Consider, for example, what one calls after Michel Albert *capitalisme rhénan* with its connotation of long-term orientation, patient investors, apprenticeship systems and Mitbestimmung. Or think of the institutional complementarities (co-investment, co-specialization), collaborative networks which arise in such environments. While this might be fading, there are certainly important remnants: the municipally owned Sparkassen with their local focus ("regional principle" – somehow not completely dissimilar to the U.S. Community Reinvestment Act of the mid-1970s). Or, to pick a different development, think of the French financial revolution of 1983 which (with its emphasis on money market funds, capital market funding more generally) made France much more Anglo-Saxon.

To be brief: We have different levels of public (not always state!) involvement, different background characteristics and philosophies – but one monetary policy. This complicates things. This leads to a crucial issue: How much financial sector variety can a monetary union accommodate? If we take the U.S. as a real-world counterfactual (we think in particular of the McFadden Act), there variety faded, though only very protractedly, in a long-drawn process.

4 SSM: De-Nationalization, Supra-Nationalization

In focusing on supervision – the factual implementation of rules through the examination and inspection process – there have been, quite obviously, national idiosyncrasies. From a bird's eye perspective, one can distinguish between two supervisory philosophies. One would try to provide for an environment of "workable" competition, implying low-margins, hence less attractive for banks, but potentially beneficial for clients. A second, more industry-oriented approach shows a stronger concern for adequate, sufficient margins (the franchise value) to allow for a healthy, stable banking industry.

With the SSM (and the Recovery and Resolution Directive), a substantial change of model is lurking. Banks cannot bank on "their" state anymore, that is, not in concept. But this implicit guarantee was clearly substantial (Schweikart and Tsesmelidakis, 2011). In the same vein: national champions will be a thing of past, European ones barely imaginable. Therefore, European banks will be largely de-nationalized, lose their national trappings.

Given the embeddedness argument referred to before, this could have significant consequences for corporate sector funding as well as corporate sector governance.

What will be decisive is to develop and implement a consistent supervisory philosophy. Examiners will become more intrusive. Having more discretion makes supervision more difficult and subject to critique, in particular when it is about learning to say no (Viñals and Fiechter, 2010).

How did we arrive here? The necessity of a banking union has meanwhile

become conventional wisdom, though first acknowledged only in the report of the four presidents (*Towards a Genuine Economic and Monetary Union*) in June 2012. However, it took a deep fragmentation of financial markets to convince the median view. Resegmentation of intra-euro area finance implied:

- A substantial impediment to the singleness of the ECB's monetary policy. This meant, in particular, a distortion of the credit channel along national lines. Thus, access to and costs of funds were significantly dependent on the nationality of borrower. This implied a plurality of monetary conditions;
- A tighter link between banks and their sovereign. Of course, in times of crisis, it was always an ambitious objective to break this nexus. Banks are somehow necessarily characterized by their local background characteristics. Local betas are larger than European betas.

Banking union, in particular the SSM, is now seen as an instrument to get the banking system going again, also implying a smoother transmission of monetary policies. Supposing it is consistently conducted, the comprehensive assessment of banks' perspectives – by means of an asset quality check and a stress-testing exercise – deals with the otherwise highly implausible uncooperative outcome in a cross-jurisdictional dimension (of which Giovanni Dell'Ariccia also spoke at this *Volkswirtschaftliche Tagung*.)

But quite obviously, SSM is barely one-third of the story – the proof of the pudding is how stressed banks will be handled. Promises not to bail out will, given circumstances, be honored in breaking. They are not credible under all skies; the temptation to re-optimize can become irresistible. Therefore, without cross-jurisdictional burden-sharing, when push comes to shove, the banking union stool is a wobbly affair.

5 Conclusion, Policy Issues

Still, Europe always advanced on the back of incomplete institutions: la méthode Monnet. Fragility, vulnerability – what was achievable under prevailing political constraints – was often a means to advance Europe's integration.

There are a number of such fragilities or open issues: Given that monetary and banking policies are joined at the hip, one might wonder: What is the optimal institutional division of labor between these two policy areas? The new European setup opts for a strict separation. In fact, some would prefer an ultimate separation, a clear alloca-

tion of responsibilities. This would indeed be a preferable option, given that conditions for separability exist. The U.K., starting from a separation baseline (established in 1997), reversed its approach, however, opting for complete integration. The Bank of England has coined a convincing headline for its new remit: *One mission, one bank,* integrating macro-, micro-prudential and monetary policy, i.e. acknowledging the inevitable interaction and spillovers. In times of crises, when central banks use their balance sheets for (financial) stabilization purposes, this is evident. But it also holds true under more normal conditions when it is useful for monetary policymakers to know about the state of their banks and supervisors to have a robust information base concerning monetary policy (Peek et al., 1999).

In my view, there are decisive arguments in favor of the Bank of England approach. But they could only be implemented in the euro area if the necessary political background conditions were in place. Banking policy is ultimately politics. And the ECB is a stateless bank, which is appropriate when it is about the objective of conducting a neutral, nation- or jusrisdiction-blind monetary policy. However, given Europe's financial market background conditions, the borderline between monetary and banking (fiscal) policy is inexorably blurred. Therefore, it is highly questionable whether a stateless (that is, a politics-free) SSM can work properly also in periods of systemic malfunctioning. At the same time, robust banking systems – and the plural will remain the appropriate tense for a while in Europe – are of the essence for monetary policy.

The ECB could not convince national policymakers (i.e. the Council) that a credible balance sheet assessment requires a fiscal backstop. Such a backstop, and not some technical stress testing mechanics, was the reason for the positive outcome in the U.S. Such a backstop is in particular important for those who would like to shield the ECB from financial dominance.

On its way to completing Europe's monetary and economic union, SSM is an important, logical step. We now see that monetary union without banking union was not nirvana, but rather, given our background conditions, a flawed setup. SSM can contribute to stronger, more robust integration of markets. It is an ambitious project indeed – starting with a due diligence on a grand scale. Of course, it is also subject to imperfections, not a panacea to all what ails Europe: for example, differences in cost and access to external funds. They do reflect different background characteristics, as they should – commensurate with distinct differences in credit risk (default probabilities). They are, however, dysfunctional when they betray break-up risk.

Sharing of sovereignty (and power) is a crucial step to completion of the Euro project, with ultimate completion always a bit elusive. This is not unlike the introduction of the common monetary policy.

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